

China: Great Wall, Great Mall, Great Fall? Not really...

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Executive summary

- *Cracks in the Wall*, our core scenario for China (60% likelihood) envisions growth of +6.8% this year and +6.5% in 2016, costing the world 0.1pp of GDP growth so far. Lower export growth, decelerating investment, less favorable financing mix and misperceptions of policy orientation are the underlying causes for this slowdown; the stock market crash was a mere artefact.
- Though domestic consumption is set to remain solid, Government and Central Bank support will eventually ramp up to address remaining instability. However, corporate insolvencies will increase by +25% in 2015, and +20% in 2016. Sectors at risk include: Construction, metals and mining, low-end manufacturing and export-related industries.
- Overall, the impact on global growth will be limited (-0.1 pp of GDP) but dramatically uneven. In the next 6 months, commodity exporters will particularly feel the heat. Indonesia and Malaysia, Peru and Chile and South Africa are tier 1 of impacted countries. Other countries linked to China's manufacturing value chain (such as Taiwan) are also at risk.
- Alternative scenarios (sharper contraction – 30% and excessive stimulus – 10%) are also considered but remain less likely. All in all, China's new model is taking shape but it does not go unnoticed.

China 2015-16: Cracks in the Wall

We revised down our growth forecast for China this year to +6.8% in 2015 and +6.5% in 2016 with a possible deviation of +/-0.2pps each year. This revision reflects lower growth in exports and investment, a less favorable financing mix and prevailing deflationary pressures. Domestic consumption is set to remain resilient with progressive improvement in private consumption. In the short term, risks are tilted to the downside as misperceptions on policy orientation continue to weigh on the outlook. In the longer term, the growth mix (strong growth in domestic consumption, higher living standards) will likely matter more than the growth target.

Private consumption growth has been resilient so far but is still not sufficient to compensate for lower export growth and reduced investment growth; the economy continues to rely on government support. Official business surveys (manufacturing PMI) reveal lower employment in industry and consumer confidence is adjusting downward following stock market corrections. The latter does not pose a systemic

Table 1: China's economic dashboard

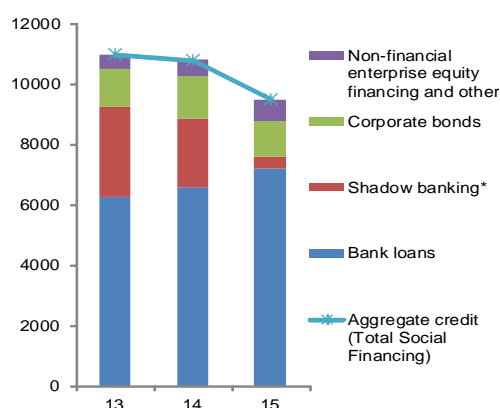
Economic activity - hard data	Mar-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15
Real industrial production (y/y)	5.6	5.9	6.1	6.8	6.0	na
Nominal Retail sales (y/y)	10.2	10.0	10.1	10.6	10.5	na
Retail sales-CPI deflated (y/y)	8.9	8.5	8.9	9.2	8.9	na
Nominal Government expenditures (y/y)	4.4	33.2	2.6	13.9	24.1	na
Nominal Investment in Fixed Assets (YTD, y/y)	13.5	12.0	11.4	11.4	11.2	na
Nominal USD Exports (y/y)	-15.0	-6.4	-2.5	2.8	-8.3	-5.5
Nominal USD Imports (y/y)	-12.7	-16.3	-17.6	-6.1	-8.1	-13.8
Trade balance (USD bn)	3.1	34.1	59.5	46.5	43.0	60.2
Financing conditions						
Credit outstanding to non fin. institutions (y/y, %)	13.5	13.6	13.8	14.0	14.6	na
Lending Rate (%)	5.35	5.35	5.10	4.85	4.85	4.60
Reserve Requirement ratios for large banks (%)	19.5	18.5	18.5	18.5	18.5	18.0
Stock market - Shanghai stock exchange (m/m)	13.2	18.5	3.8	-7.3	-14.3	-12.5

Sources: IHS, Euler Hermes

threat so far. However the cyclical risk is significant especially on household confidence. Public support will increase at a stronger pace to support growth in the form of infrastructure and social spending, lower taxes for vulnerable companies and better financing conditions. Private consumption is set to accelerate gradually thereafter.

Financing conditions are not supportive enough. Authorities want to decrease concentration risks through a slowdown of corporate debt and diversification of financing channels. Credit intensity (the amount of credit needed to generate one more RMB of growth) has deteriorated in recent years and now China needs close to +RMB3.3 of new credit to create +RMB1 of growth (compared to RMB1.8 in 2011). Formal credit is increasing but its growth rate is not enough to compensate for the reduction in shadow banking activities. Financial market effectiveness has deteriorated significantly during the summer and the economy has to rely more on bank credit to grow. In Jan-Jul 2015, China provided +RMB9.5tn of new credit to the economy with +RMB7.2tn coming from the banking sector. To achieve a growth of +RMB5tn (+8% nominal growth), China will need to provide +RMB16.7tn of new credit this year, +RMB13.6tn in bank credit.

Graph 1: Aggregate credit flows (Jan-Jul, cumulated, RMB bn)



* Using IMF dissemination, it refers to trust loans, entrusted loans and bank acceptances

Sources: IHS, Euler Hermes

It's the policy, stupid!

Misperceptions of policy orientation will continue to weigh on the outlook. In a world where major economies tend to be transparent on their policy orientation, the unexpected change in the exchange rate formation mechanism and the following currency devaluation have been seen as an early indicator of worsening economic activity and the beginning of a continued currency depreciation. Timing (right after disappointing data releases) and change in methodology contrasted markedly with previous announcements (including extensions of the currency trading band in July).

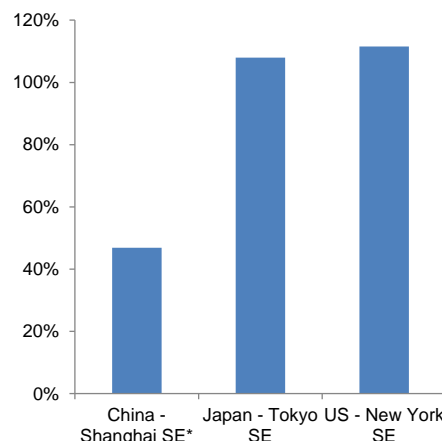
Going forward, easing measures and a revamp of economic guidance are expected. With ongoing financial instability and weak economic data, the government is set to increase support

measures. These include: direct support to growth through higher public expenditures and higher credit supply but also indirect measures such as the development of other formal financing channels such as finance companies and trade credit insurance. Recent measures (cuts in both policy rate and Reserve Requirement Ratios, reduction in corporate income tax) will probably start to bear fruit in Q4 due to the time lag in policy transmission. Regarding financial markets, the authorities are likely to increase financial buffers (further liquidity injections) to avert further correction. On top of these easing measures, we expect a progressive revamp of China's economic guidance, with more reasonable and more flexible growth targets (perhaps a range of +6% to +6.5%) and with more focus on the growth mix than the growth rate itself. This will help to reduce the extreme sensitiveness to hard data financial markets have experienced so far.

Financial volatility is set to remain elevated but systemic risk will be contained. First, Eurozone hiccups and currency carnage in emerging markets put pressure on the Chinese export model. Second, China's internal transformation is kicking in (see table 2) and the banking system and private sector need to adapt, creating some volatility along the way. However, systemic risk linked to the stock market crash is not plausible as financial markets in china are not deep enough: Market capitalization of major stock exchanges is lower than 50% of GDP (see Graph 2). The authorities still have the upper hand with Reserve Requirement Ratios and high policy rates. Households also have some buffers as income revenues are still on a positive trend and savings are significant (urban households saving rates is close to 30% GDP). Companies will probably be those which will bear the brunt of the adjustment in the short run, especially financial services.

The renminbi has re-pegged and should not depreciate sharply. Since poor export performance is linked to external demand, currency should not be tampered too much. China's export market share is still increasing (see Graph 3) but price competitiveness has eroded because of increasing labor costs. Non-price competitiveness has increased significantly through innovation and better positioning though. Downward pressures on the

Graph 2: Domestic market capitalization (% GDP)



SE* refers to Stock Exchanges

Sources: World Federation of Exchanges, IHS, Euler Hermes, July 2015

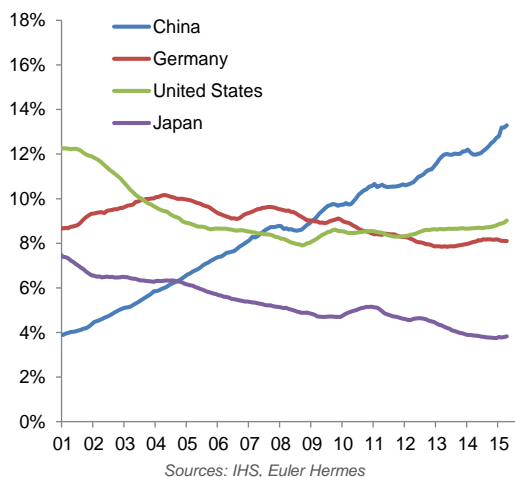
renminbi do exist (correction after sharp appreciation, investors' concerns about China's economy and diverging monetary policies). Assuming that China gradually eases control of the currency, we foresee a maximum deviation of +10% (from 6.36 RMB/USD), which will bring the RMB/USD parity to 7 over one year. The potential impact on net trade will be positive (+0.2pp of GDP).

Table 2: Financial liberalization – key actions

Financial liberalization - key actions	
2014	<ul style="list-style-type: none"> • RMB trading band widened from 1% to 2% • Foreign investors on Shanghai Comp allowed to invest in more products and up to 30% in single company (vs. 20%) • Shanghai-Hong Kong Stock connect is launched
	<ul style="list-style-type: none"> • PBoC cut benchmark lending and deposit rates; deposit rate ceiling raised from 1.1 times the benchmark level to 1.2 times
	<ul style="list-style-type: none"> • PBoC widens deposit base for banks in banks loan to deposit ratios
2015	<ul style="list-style-type: none"> • Government issues guidelines for further Free Trade Zones • PBoC increased availability of its Short-term Liquidity Facility to allow more banks to get 1-3 month liquidity
	<ul style="list-style-type: none"> • PBoC cut benchmark lending and deposit rates; deposit rate ceiling raised from 1.2 times the benchmark level to 1.3 times • Governor Zhou - "probability of full interest rate liberalization by the end of the year is high"
	<ul style="list-style-type: none"> • Primer Li - "China will speed up the basic convertibility of RMB on the capital account" • Mutual funds got access to Shanghai-Stock connect • IMF announces that RMB on path to inclusion in SDR basket
2015	<ul style="list-style-type: none"> • Mainland Chinese buying of Hong Kong share via Shanghai-Hong Kong stock connect reaches daily quota for first time • Deposit insurance scheme goes live. The insurance system will guarantee deposits of up to 500,000 RMB (\$81,000).
	<ul style="list-style-type: none"> • PBoC cut benchmark lending and deposit rates; the ceiling for deposit rates was raised to 1.5 times the benchmark level (from 1.3)
	<ul style="list-style-type: none"> • PBoC cut benchmark lending and deposit rates
2015	<ul style="list-style-type: none"> • Chinese State Council announced that China will widen RMB trading band soon
	<ul style="list-style-type: none"> • Change in exchange rate formation mechanism: the daily opening fixing rate of the RMB is based on the previous trading day's closing • PBoC cut benchmark lending and deposit rates; abolition of the cap on deposit rates with maturities over one year • Loan to deposit-ratio scrapped (75% before)

Sources: Scotia Bank, local press, Euler Hermes

Graph 3: China's global export share (12m rolling average)



Sources: IHS, Euler Hermes

What does it mean for credit risk in China?

Corporate insolvencies will increase by +25% in 2015 and +20% in 2016. Insolvencies increased by +13% (12m/12m) in July. To date, industrial profits for large companies remain on a downward trend (-1% YTD, y/y in Jan-July). With an improvement in credit conditions domestically and a gradual increase in global demand (both domestic and external) from Q4 2015 onwards, the increase in insolvency should be contained in 2016. Note that Insolvencies number in 2016 (3920) will remain below 2009 level (4448).

Sectors at risk include: Construction, metals and mining, low-end manufacturing and export-related industries. To date, only some sectors in the higher-end segment and within government targets are showing signs of resilience (high-tech, chemical and commodity processing). The construction sector is particularly struggling as downward price pressures prevail with large overcapacity and weak demand prospects. Primary commodity for manufacturing such as metals and mining experience a perfect storm: lower commodity prices, lower demand from domestic industries (such as construction) and lower external demand. We also see increasing risks in low-end manufacturing and sectors driven by external demand (textile and low-end electronics). These sectors suffer from stronger regional competition (from Vietnam and Bangladesh). For electronics the contraction in Taiwan (one of the biggest suppliers of electronic components to China) in Q2 (-1.7% q/q) should nudge the sector this quarter.

Who is impacted outside China?

Overall, the impact on global growth will be limited (-0.1 pp of GDP) but dramatically uneven. In the next 6 months, commodity exporters will feel the heat. Commodity exporters are affected by both the price shock and the demand shock by China (both of them being related). Growth forecasts have been lowered and the upcoming Fed hike will probably exacerbate external vulnerabilities and shave off more growth. In Asia, Malaysia and Indonesia are primary victims due to existing imbalances, including a current account deficit (for Indonesia) and large public deficits and high household debt (in Malaysia). Policymakers will focus on ensuring financial stability, Thailand and Vietnam will also be affected. Australia and New Zealand are also on the radar but policy response is more effective and public debt is low. Outside Asia, Latin American countries, such as Chile and Peru and African countries such as South Africa will also be impacted. For a full list of countries at stake, see table 3 for net trade surpluses with China, and policy room to manoeuvre.

The second tier of impacted markets include those dependent on China's manufacturing value chain such as South Korea, Taiwan, Singapore, Hong Kong and, to a lesser extent, Japan. Most of these countries have strong buffers

(monetary policy and sound public finances). They can withstand a cyclical shock (sharp deceleration in China) but in the longer term they will have to adapt to the Chinese new normal. Taiwan is probably the most vulnerable as its economy is highly linked to China's electronics industry. With China trying to move up the value chain and being more autonomous in terms of production, the situation will be more challenging for Taiwanese companies.

Other trade partners such as Germany will feel some cyclical headwinds due to large export exposure but strong positioning will allow solid performance. Turnover growth for exporters should be revised slightly downward as private demand is improving but moderately and local competitors are emerging, in spite of the adverse financing conditions. Most exposed sectors include automotive and machinery. However, strong positioning on quality products, technological advantage and agility to new Chinese model (more quality friendly) can help prove resilient.

If push comes to shove...

Our alternative scenario *The Fall* (30% probability) includes a sharp deceleration in private expenditure coupled with insufficient policy support. GDP growth will slip to +6.5% (or below) this year and around +6% in 2016. Corporate risks will intensify especially in traditional industries and highly subsidized ones (high-tech electronics, e.g.). Confidence will continue to fall and external financing will tighten (large capital outflows). This could trigger a large currency depreciation (up to 25%), probably buffered by other Central Banks, but reinforcing deflationary pressures. Under this scenario, the direct impact on global growth will be more significant (-0.3 pp of global GDP) and export revenues will be affected beyond commodity exporters and traditional Chinese providers. In particular, high-end goods exporters (including the U.S., Germany and France) will be affected in specific key industries such as electronics for the U.S., machinery and equipment for France and the automotive industry for Germany. See table 4 for export exposure to China by country and sector.

Least likely scenario for us, *Overshoot and postpone* (10% probability) would mean excessive support à la 2009. GDP growth will be above +7% this year and above +6.8% next year (+0.1pp for world GDP in 2015). But this would be putting off the evil hour: increase in corporate debt further and maintained overcapacity would hinder rebalancing through further increase in (low return) investments. By Q2 2016, we will be back to where we are today, with the same structural problems to solve.

Table 3: Five vulnerability indicators to China's deceleration

	Primary commodity (net exports) % GDP	Non-primary commodity (net exports) % GDP	General government net lending (% GDP, 2014)	General government debt (% GDP, 2014)	Currency depreciations (July 2015, y/y)
Saudi Arabia	5.5%	-2.0%	-0.5	2%	0%
Kazakhstan	4.8%	-3.8%	1.9	15%	-2%
Australia	4.8%	-1.7%	-3.6	34%	-22%
Chile	2.9%	-1.6%	-1.4	14%	-15%
Peru	2.9%	-2.8%	-0.1	21%	-13%
South Africa	2.9%	-3.7%	-4.1	46%	-15%
Uruguay	2.5%	-3.5%	-3.4	63%	-18%
Vietnam	2.5%	-24.1%	-5.4	59%	-2%
Venezuela	2.3%	-1.4%	-14.8	46%	-14%
Indonesia	1.9%	-3.1%	-2.2	25%	-14%
Thailand	1.9%	-2.8%	-1.8	47%	-9%
Brazil	1.7%	-1.5%	-6.2	65%	-33%
Ukraine	1.4%	-4.8%	-4.5	71%	-44%
Malaysia	1.4%	1.8%	-3.7	57%	-16%
Russia	1.3%	-2.4%	-1.2	18%	-41%
New Zealand	1.3%	-0.2%	-0.6	34%	-22%
Colombia	1.2%	-2.5%	-1.4	38%	-35%
Philippines	0.8%	-2.0%	0.5	37%	-5%
Taiwan	-0.2%	12.6%	-2.5	38%	-5%
Hong Kong	-0.9%	-7.6%	5.3	7%	0%
South Korea	-0.1%	6.4%	0.3	36%	-12%
Singapore	0.0%	0.2%	4.2	99%	-9%

Legend

Orange cells mean that	The country has positive surplus with China	General gov't, net lending is below -3% GDP	General gov't debt is above 60% GDP	Depreciation is higher than 10 %
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Sources: Chelem, Euler Hermes

Table 4: Export exposure to China (share of the sector in a country's total exports to China)

	Energy	Food agric	Textiles	Chemicals	Iron steel	Non ferrous	Machinery	Vehicles	Electrical	Electronic
Australia	11%	10%	0%	1%	58%	9%	0%	0%	0%	0%
Canada	8%	37%	0%	10%	10%	10%	6%	1%	1%	2%
Saudi Arabia	82%	0%	0%	18%	0%	0%	0%	0%	0%	0%
United States	2%	24%	1%	14%	2%	6%	10%	8%	3%	13%
India	4%	22%	15%	18%	9%	14%	5%	1%	1%	2%
Russian Federation	65%	11%	0%	7%	4%	7%	4%	0%	0%	0%
South Africa	6%	3%	0%	3%	39%	32%	1%	1%	0%	0%
Turkey	0%	3%	8%	35%	3%	36%	3%	0%	1%	1%
Argentina	13%	80%	3%	3%	1%	0%	0%	0%	0%	0%
Brazil	9%	44%	1%	2%	35%	3%	1%	0%	0%	0%
Mexico	8%	2%	1%	6%	9%	21%	3%	17%	7%	24%
France	0%	12%	3%	15%	2%	2%	44%	4%	5%	7%
Germany	0%	2%	1%	11%	1%	2%	32%	26%	10%	10%
Italy	0%	3%	15%	14%	2%	2%	39%	7%	4%	5%
United Kingdom	2%	3%	1%	14%	2%	6%	16%	39%	2%	7%
Indonesia	36%	15%	3%	10%	3%	21%	1%	0%	3%	3%
Japan	1%	0%	2%	19%	6%	3%	18%	9%	10%	25%
South Korea	6%	1%	2%	20%	3%	2%	9%	4%	13%	40%
World	20%	9%	2%	13%	8%	7%	8%	5%	5%	18%

Between 10% and 20%

More than 20%

Less than 10%



Sources: Chelem, Euler Hermes

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